Internal Revenue Service
memorandum

CC:TL-N-6569-88
Brl:CEButterfield

date: JUL 13 1988

to: District Counsel, Milwaukee CC:MIL

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice dated May 20, 1988.

ISSUES

1. Whether, under the dollar value, double extension method of LIFO inventory evaluation finished goods acquired by way of bargain purchase should be separated into a separate LIFO pool from finished goods manufactured by the acquiring corporation. 0472-0300

2. Whether, under the dollar value, double extension method of LIFO Inventory evaluation, finished goods acquired by bargain purchase should be treated as a separate item from manufactured finished goods of the acquiring corporation. 0472-0300

CONCLUSIONS

1. The regulations clearly provide that manufactured items and purchased finished goods must be maintained in separate inventory pools.

2. Because of the position taken that separate pools are required to account for the manufactured and purchased inventories, the separate item issue should only be raised as a secondary argument, in the event that the separate pool argument is unsuccessful.

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FACTS

On [redacted], [redacted], a wholly owned [redacted] subsidiary, purchased the assets of a lawn and garden manufacturing company formerly operated by [redacted]. Included in the purchased assets were inventory items with tax bases as follows:

Raw Materials:	$[redacted]
Work in Process	$[redacted]
Finished Goods	$[redacted]

Taxpayer uses the dollar-value LIFO inventory method. To compute incremental changes in value at the close of each tax year (taxpayer uses a fiscal year ending June 30) taxpayer uses the link-chain method.

During the four month period between the asset acquisition and the close of the taxable year [redacted] valued its goods in progress and finished goods in the same natural business unit pool. [redacted]'s costs of manufacturing were the same as their predecessor's. In reporting inventory values for the end of the fiscal year, [redacted] used figures based on the [redacted] discounted purchase price. Reported values for FYE [redacted] were as follows:

Raw materials	$[redacted]
Work in Progress	$[redacted]
Finished Goods	$[redacted]

These values represent a discount of approximately [redacted]% over the cost of manufacturing common to both [redacted] and [redacted]. By the close of the year all the finished goods had been turned over, and the only goods actually remaining in inventory were those that had been produced by [redacted], although the value of those goods was based on the bargain purchase price of finished goods.

LEGAL ANALYSIS

The LIFO method is permitted by I.R.C. § 472. Treas. Reg. § 1.472-8(a) further authorizes a LIFO taxpayer to elect the dollar value method, rather than accounting for inventories by specific items. Manufacturers who use the dollar value method group inventory items into pools. The pools are to consist of all inventory items in the same natural business unit (NBU). Treas. Reg. § 1.472-8(b)(2) defines NBU pools for manufacturers to consist generally of "the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods." The requirements of the regulations continue that "[w]here a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered part of any manufacturing or processing unit." Treas. Reg. § 1.472-8(b)(2).

As the private letter ruling in this case already indicates, the placement of goods in a single NBU pool is a question of fact, to be decided based on the individual circumstances of the case. PLR 8545004. However, the purpose of allowing the LIFO method and the use of NBU pools within that method is to confine the effects of cost fluctuations to the single product lines most directly effected by those fluctuations. Goods purchased in the bargain purchase of an acquired company are not subject to the same market effects as those manufactured within the acquiring corporation. Inclusion of discounted goods in the same NBU pool with manufactured goods introduces elements into the price structure of the pool beyond the inflationary effects that were intended to be reflected by the method. The result skews normal LIFO assumptions.

The Service has favorable precedent for the position that separate pools are required in Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984). Of course we are faced with the factual distinction that the taxpayer in Amity Leather was in the regular practice of purchasing substantial portions of its inventories as finished goods from foreign suppliers. In that case the purchases included a profit, rather than reflecting a bargain purchase, but the reasoning against their being included in the same pools with manufactured goods is the same --the same factors are not at work to create the costs. While Amity Leather may be partially distinguishable, it does support the argument that the requirement of the regulation that manufactured and purchased goods must be pooled separately should be read literally. Rev. Rul. 82-192, 1982-2 C.B. 103.

The taxpayer in this case is attempting to argue that the regulations refer not to single purchases but to continuous retailing or wholesaling activities, probably carried on by subsidiaries of the manufacturer. The regulations do not describe a de minimus exception, however, and we see no reason to create one. For further discussion of these arguments see the attached copy of the brief filed in Amity Leather.

You have also raised the argument that if the purchased inventory is not to be accounted for in a separate pool it should be treated as a separate item in the same pool. The attached brief indicates that we argued a contrary position in Amity Leather. The taxpayer was successful in persuading the court in Amity Leather that the item in question should be treated as a separate item. We agree with your arguments that separate item treatment would be appropriate here, if the primary argument that separate pools are required were unsuccessful, and we agree to its being raised as an alternative argument.

The Amity Leather brief indicates some of the arguments that petitioner might raise in this case against the separate item assertion. Amity Leather itself supports the argument. In Amity Leather the court concluded that a narrow definition of the term "item" (which is not defined in the statute or regulations) obtains a more accurate price index. The billfolds in Amity Leather which the taxpayer wished to treat as a separate item were physically indistinguishable from their domestically manufactured counterparts. The factor emphasized by the taxpayer was that their manufacture in Puerto Rico meant that they were subject to different cost pressures than identical products manufactured in the contiguous United States. The taxpayer argued, and the court accepted, that the inclusion of these less expensive billfolds in the base year cost calculation with the more expensive goods partially offset the effects of inflation to which the more expensive goods were subject. On the other hand, separate item treatment more accurately eliminates the effects of inflation from the income calculation. Clearly these arguments are applicable to the identical goods in this case, that were purchased at a bargain price.

Generally fewer pools or fewer items are to the taxpayer's advantage, because it is less likely that an inventory layer will be liquidated in any year, removing lower priced goods from the inventory and replacing them with higher priced goods. This effect is compounded when an item in inventory is purchased at a bargain price, because not only is the layer larger, thus less susceptible of liquidation, the base cost is lowered by the addition of the bargain purchase goods. This counters the normal assumptions of the LIFO method, by which increases in costs are to be accounted for in flow assumptions and not by reductions in base prices. While the Tax Court has restricted the requirement to treat items separately where there are minor differences in style or price, Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447 (1979), they recognized in Amity Leather that substantial differences in costs warranted separate item treatment.

Our conclusion is that the primary argument raised in this case should be the assertion that the literal language of the regulation requires that purchased goods be accounted for in a separate pool, and that there is no exception to this requirement for a one-time purchase. (Nor, we would point out, is there any guarantee that similar purchases would not be made by this taxpayer in the future.) The primacy of this argument is necessary for consistency in our litigating position. We agree, however, that there is great validity to the separate item argument as an alternative in the event that we do not prevail on the argument regarding separate pools, and we support your decision to raise it. Provided we have continued success on the pool requirement, the item argument will retain its secondary status. Until we have some reason to reconsider the strict interpretation of the pooling requirements, we do request that the item discussion be raised only as an alternative position.

If you have any questions with regard to this matter, please do not hesitate to contact Ms. Clare E. Butterfield, at (FTS)566-3442.

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Attachment:
Amity Leather brief